JLSt.Germain
CC:IT&A:03

Coordinator, Financial Institutions Officer/SH IC: 4425 SSAT
Dallas District

Assistant Chief Counsel (Income Tax & Accounting)

Taxation of Loans from Failed S&L's

You have requested advice on how to approach the taxation of borrowers on delinquent loans from failed S&L's. This memorandum discusses 1) situations in which income is realized upon the origination of the purported loan because the transaction can be recharacterized as a) income from fraudulent activities, b) a dividend, or c) compensation; and 2) situations in which no income is realized until cancellation of the loan, and when a loan is considered cancelled. This memo provides only general guidance, in the absence of specific facts. If you submit requests for technical assistance on specific sets of facts we can be more specific in our response, and we will attempt to respond in a timely way.

Background

Failed S&L's are commonly found to have made bad loans to shareholders and officers and to unrelated third parties who obtained the loans from the S&L's through deceit and misrepresentations. The borrowers continue to assert that they intend to repay these loans even though payment appears doubtful. In many cases the statutory period of limitations on assessment and collection has expired for the years the loan proceeds were received.

Taxation of Loan Proceeds When the Loan Originated

The first question should be whether a bona fide loan was made. For a bona fide loan to exist, the taxpayer must intend to repay the loan when the loan proceeds are received, with the lender's "consensual recognition, express or implied," of the obligation to repay. James, 366 U.S. 213, 219 (1961); See also Fisher v. Commissioner, 54 T.C. 905 (1970). If it is a bona fide loan, the proceeds are not includible in gross income upon receipt. See James, 366 U.S. at 213; United States v. Rochelle, 384 F.2d 748 (5th Cir. 1967), cert. denied, 390 U.S. 946 (1968). If it is not a bona fide loan, the next step is to determine whether it is income from fraudulent activities, a dividend, or compensation.

008718

Income from Fraudulent Activities

Loans received by unrelated third parties that do not qualify as bona fide loans will usually fall into the category of income from fraudulent activities and should be evaluated in light of the following cases. Loans received by insiders, such as officers, directors, and shareholders, that are not bona fide may also be attacked as income from fraudulent activities, however, compensation or dividend treatment may be more applicable, depending on the facts.

Money obtained by embezzlement is includible in the embezzler's income in the year embezzled. James, 366 U.S. at 213. Similarly, loan proceeds obtained by deceit and misrepresentation may be includible in income in the year received. However, the deceit and misrepresentations must be of a kind to negate an intent to repay and a "consensual agreement" between the borrower and the lender. One may lie to obtain a loan and yet honestly intend to repay it. See Gilbert v. Commissioner, 552 F.2d 478 (2d Cir. 1977); Rosenthal v. United States, 470 F.2d 837 (2d Cir. 1972), cert. denied, 412 U.S. 909 (1973); Moore v. U.S., 412, F.2d 974 (5th Cir. 1969); Rochelle, 384 F.2d at 748; McSpadden v. Commissioner, 50 T.C. 478 (1968); Kreimer v. Commissioner, T.C.M. 1983-672.

Perhaps the closest case to your cases involving loans obtained by misrepresentation and falsified loan documents is Rosenthal v. United States, 470 F.2d at 837. In Rosenthal, the Court of Appeals upheld the taxpayer's conviction for tax evasion. The taxpayer in that case obtained loans from banks by using financial statements containing significant misrepresentations about his net worth and annual income. The court held that

> the evidence also showed Rosenthal was incurring obligations that he must have known to be far in excess of his ability to repay. Thus, from the fraudulent practices utilized in getting several of the loans, from the volume of the loans and the fact that defendant was involved in identical borrowing practices with several banks, and from the fact that defendant never did repay the loans, the jury could find that Rosenthal knew he would not be able to, and that he did not intend to, repay the loans at the time that he received the funds.

470 F.2d at 841. The court did not accept the taxpayer's contention that he was merely an "over-optimistic" borrower but held that the defendant was in the business of "fraudulently

deriving funds, in the form of loans, from financial institutions." Id. at 842.

In Rochelle, 384 F.2d at 748, the court was faced with an elaborate confidence scheme, and held that money received by the taxpayer as "loans" to finance non-existent businesses was taxable to him in the years the money was received.

The following cases illustrate circumstances where the Service argued that the taxpayers had income from fraudulent activities and where the courts held the loans were bona fide.

A loan may still be treated as a bona fide loan even if it was obtained fraudulently. In Kreimer, T.C.M. 1983-672, even though the taxpayers were convicted of fraud, the court held the funds received were excludable from gross income as loan proceeds. The taxpayers obtained the loans by having another entity apply for and receive the loan and then transfer the loan proceeds to the taxpayer. The bank was not aware of the identity of the real borrower. The court stated that "a finding of fraudulent conduct does not in itself establish a lack of intent to repay." The court found the following factors evidenced the taxpayers' intent to repay the loans. The taxpayers assumed the loans pursuant to written agreements and also executed indemnification agreements. The taxpayers paid interest on the loans and had a sufficient net worth and cash flow from their business to repay the loans. The loans were in fact repaid in full. Kreimer may be useful to you in situations where the loan was tainted with fraud but where you prefer to treat some later event as the realization of income.

In Gilbert, 552 F.2d at 478, the taxpayer, who was the president, principal stockholder, and a director of E.L. Bruce corporation, withdrew funds from the corporation in order to meet margin calls on his purchase of Celotex stock he was acquiring to bring about a merger with Bruce. There was a lot of evidence to indicate that Gilbert intended the withdrawals to be bona fide loans and intended to repay the loans even though he lacked the necessary corporate authorization for the loans. Although Gilbert informed some of the directors of the corporation of the withdrawals, he did not inform them all and subsequently was convicted of unlawfully withdrawing funds from the corporation. The court concluded that

> where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty he will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does

> not realize income on the withdrawals under the James test. When Gilbert acquired the money, there was an express consensual recognition of his obligation to repay: the secretary of the corporation who signed the checks, the officers and directors to whom Gilbert gave contemporaneous notification, and Gilbert himself were all aware that the transaction was in the nature of a loan. Moreover, the funds were certainly not received by Gilbert "without restriction as to their disposition" as is required for taxability under James; the money was to be used solely for the temporary purpose of meeting certain margin calls and it was so used.

552 F.2d at 481 - 82. The Circuit Court reversed the Tax Court's finding that Gilbert realized income as a result of the unauthorized withdrawals. This case illustrates the problems of finding income in cases involving insider loans.

You may be able to distinguish Kreimer and Gilbert from S&L borrowers who engaged in egregious misconduct since in Kreimer and Gilbert, the court seemed to believe the taxpayers were basically honest businessmen.

Loan Recharacterized as a Dividend

Loans to shareholders of the S&L that are not bona fide may be recharacterized as dividends. For the advance to be treated as a loan, the parties must intend to create a bona fide creditor-debtor relationship. A loan exists if the parties intended that the advances would be repaid. Whether the parties have the requisite intent is solely a question of fact, to be determined by an examination of all the circumstances. Busch v. Commissioner, 728 F.2d 945 (7th Cir. 1984). The court will consider objective factors as well as the parties' testimony. Such factors include: extent of control that the shareholder receiving the advance exercises over the corporation; the retained earnings and dividend history of the corporation; the size of the advance; the presence of indicia of debt, such as promissory notes, collateral, and provision for interest; treatment of advance in the corporate record; the history of repayment; and the taxpayer's use of the funds. See Alterman Foods, Inc. v. United States, 505 F.2d 873, 876 (5th Cir. 1975). If the agreement does not manifest any absolute duty to repay, but rather the repayment is at the sole discretion of the debtor, then there is not sufficient intent to create debt. Alterman, 505 F.2d at 879.

If the parties cannot prove intent by a preponderance of the evidence, the advance is presumptively a constructive dividend under section 316 of the Internal Revenue Code, to the extent the corporation has earnings and profits. See Commissioner v. Makransky, 321 F.2d 598, 601 (3d Cir. 1963); In re Otis & Edwards, P.C., 55 B.R. 185 (Bankr. E.D. Mich. 1985).

Even if the loan is determined to be bona fide, if it carries a below market interest rate, sections 7872 and 1274(d) of the Code may apply so that interest is imputed on the loan equal to the difference between market interest and the stated interest. In such a case, the shareholder will be deemed to have received a dividend (on a demand loan, the amount of the imputed interest) and may deduct both the interest paid and the imputed interest, subject to sections 163(d), 163(h), 265, and 267.

Loan Recharacterized as Compensation

Loans to an officer of a corporation may be recharacterized as compensation. According to the Tax Court, "an essential element is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment." Fisher, 54 T.C. at 909-10; see also Beaver v. Commissioner, 55 T.C. 85 (1970); Haber v. Commissioner, 52 T.C. 255, aff'd, 422 F.2d 198 (5th Cir. 1970); Weiland v. Commissioner, T.C.M. 1982-601; Nix v. Commissioner, T.C.M. 1982-330. Some of the factors that these cases held to be indicative of the required intent to repay and the intent to enforce repayment are substantial repayment, collateral or security for the loan, charging of interest, and a fixed repayment schedule.

In Fisher, 54 T.C. at 905, the taxpayer, president of the corporation, executed two unsecured interest bearing demand notes to the corporation. The court found that the notes were compensation rather than bona fide loans. The following factors indicated a lack of intent to repay by the taxpayer and intent to enforce repayment by the corporation. The taxpayer was insolvent and his home had been taken through foreclosure at the time the corporation was allegedly lending him money. The salary he received from the corporation was his only source of income. No repayment was ever made of either principal or interest. The court found that the "loans" were really compensation to the taxpayer since the services the taxpayer rendered to the corporation were worth more than his stated salary.

In Nix, T.C.M. 1982-330, the taxpayers who were shareholders and officers of the corporation signed interest bearing promissory notes for the amounts advanced to them by the corporation. The court held that these advances did not constitute bona fide loans to the taxpayers but were compensation. The court discussed several factors which lead it

to its decision. The court stressed the importance of substantial repayment of interest and principal as more persuasive than the mere existence of a formal note. The advances increased each year even though there was no repayment for prior year's advances. Advances were made regularly and were characterized in the corporate disbursements journal as salary advances. The notes were unsecured despite substantial assets which could have been used as security. There was no schedule for repayment or ceiling on the amount advanced. Repayment was contingent upon the corporation operating at a profit and at the discretion of the taxpayers.

Therefore, even in the absence of deception, to the extent the S&L's made loans that were not bona fide to insiders of the S&L, the borrowers may have income, either as a dividend or compensation, when the loan proceeds are received.

Treating a "Loan" as Bona Fide even though It could have been Attacked as Income from Fraudulent Activities, a Dividend, or Compensation

It appears that where there are elements of fraud in the loan, but you choose to treat it as a real loan and assert tax liability upon discharge, it is not open to the taxpayer to argue that there never was a real loan. The need to tax dubious "loan" proceeds at a time other than when they are received was addressed in Bartel v. Commissioner, 54 T.C. 25 (1970). In that case, the taxpayer, the president and sole shareholder of the corporation, made withdrawals from the corporation that were carried on the books of the corporation as loans. Upon liquidation of the corporation, the Commissioner determined that this account constituted loans to the taxpayer that were being cancelled, resulting in discharge of indebtedness income. The taxpayer contended that the withdrawals were in fact dividends at the time they were received. Since the statutory period of limitations on assessment and collection had expired on the years the funds were received, the taxpayer would have escaped taxation if the court held that the withdrawals were dividends. The court held that since the taxpayer treated the withdrawals as loans, the taxpayer had to be consistent and could not now claim that the loans were actually dividends. Although this represents only one Tax Court case, the decision is on point, well-reasoned, and contains useful arguments to rebut arguments the taxpayers may make.

Realization of Discharge of Indebtedness Income

Discharge of indebtedness income occurs when a taxpayer is released from indebtedness. United States v. Kirby Lumber Co., 284 U.S. 1 (1931). A debt may be discharged when the taxpayer buys back the debt for less than the face amount as in Kirby Lumber, when the creditor and debtor agree to settle the debt for

less than the full amount owed, or when the creditor simply cancels the debt. Discharge of indebtedness income also results when the debt is discharged in a bankruptcy proceeding. However, under section 108 of the Code, the bankrupt debtor must exclude the resulting cancellation of indebtedness income from his gross income and reduce his tax attributes.

If none of these events have occurred, the substance of the transaction determines whether a debt is discharged. At the point in time that it becomes clear that a debt will never be paid, such debt must be viewed as discharged.

Realization Upon Expiration of the Statute of Limitations

The general rule is that if there are no other easily "identifiable events" indicating that the debt has been discharged, the debt is discharged when under state law the statute of limitations bars the collection of the liability.[1] Securities Co. v. United States, 85 F. Supp. 532 (S.D. New York 1948); L. R. Schmaus Co., Inc. v. Commissioner, T.C.M. 1967-197, rev'd on other grounds, 406 F.2d 1044 (7th Cir. 1970). In Securities Co., the creditor did not perform any act of cancellation or forgiveness of the debt. Instead, the creditor merely failed to act within the statutory period and thereby made available to the debtor a defense. The court held that the running of the statute of limitations released the debtor from liability on the notes, and therefore, the debtor must realize the taxable income.

In Schmaus Co., Inc., a creditor continued to do business with the taxpayer for many years after the debt was incurred but not paid. T.C.M. 1967-197. The court found that the creditor continued to do business with the debtor in order to keep the valued customer. Based upon these facts, it held that the discharge of indebtedness was realized upon the expiration of the statute of limitations.

Similarly, in Miller Trust v. Commissioner, 76 T.C. 191 (1981), the court held that the decedent's estate realized income from discharge of indebtedness when the creditor failed to file a claim against the estate by the time required under local probate law.

---

[1] Our preliminary research indicates that in Texas the statute of limitations on beginning suit for collection of a debt is four years. Tex. Civ. Prac. & Remedies Code Ann. section 16.004 (Vernon 1991). However, you should consult with District Counsel to determine whether this is the correct answer for all cases, and what kind of events can toll the statute under Texas law.

Additionally, the Service has concluded that the amount of the unpaid balance on a defaulted student loan made by the Department of Education constitutes forgiveness of indebtedness income to the student/debtor in the year that the statute of limitations for the collection of the debt expires.

An exception to the general rule was found by one court when it concluded that the realization of discharge of indebtedness occurred after the statute of limitations expired. Bear Mfg. Co. v. United States, 430 F.2d 152, 154 (7th Cir. 1970), cert. denied, 400 U.S. 1021 (1971). In Bear Mfg. Co., the Seventh Circuit Court determined that upon the debtor's transfer of accrued royalty expenses to the surplus account that the debtor realized discharge of indebtedness, rather than three years earlier when the statute of limitations on collection expired. The court reasoned that a debtor may choose, for credit purposes or other sound business reasons, to acknowledge and pay a liability after the statute of limitations has run, therefore the debt is not discharged upon the expiration. The reasoning in this case is questionable, even though the Service succeeded in locating the realization event in an open year. It does not appear that the taxpayer, in fact, did anything to revive the running of the statute. To the contrary, the taxpayer vigorously asserted throughout that it did not intend to pay the creditor. The accrual and deduction of the contested debt was dubious. It appears that the result should have been supported by a tax benefit theory.

Realization upon Write-off for Book Purposes by the Creditor

You have asked whether discharge of indebtedness income may be triggered when the S&L writes the loans off as bad debts on its books and takes a bad debt deduction on its corporate tax return. Courts do not seem to consider these events as determinative for purposes of triggering discharge of indebtedness income. Although in Hudson v. Commissioner, 99 F.2d 630, 632 (6th Cir. 1938), cert. denied, 306 U.S. 644 (1939), the Sixth Circuit Court held that debt cancellation income was realized when a corporation wrote off a stockholder's debt, since the book entries clarified the vague and indefinite position of the corporation as creditor. The court noted that book entries, while of evidential value, are not necessarily determinative of tax liability. However, this case seems to be easily distinguishable since the debts involved withdrawals from a closely held family corporation by the family members. The Board of Directors passed a resolution saying that the debts would be charged to surplus but not forgiven. The corporation then deducted the debts from the undivided profits of the corporation and credited the debtor's accounts on its books. The court found the resolution made the status of the debts uncertain but that the book entries by the corporation clarified the status of the

debts as forgiven. The court went on to hold that this debt forgiveness was a dividend to the taxpayers involved.

Affect of the Closure of the S&L

Generally, the closing of the S&L will not be an "identifiable event" for purposes of triggering discharge of indebtedness income. Another entity, such as the RTC, FDIC, Texas Banking Commissioner, bankruptcy trustee, or an acquiring bank, will usually succeed to the S&L's rights to collect the loan. Therefore, the debtor has not been released from the indebtedness.

Conclusion

For a bona fide loan to exist, the borrower must intend to repay the loan and the lender must have had "consensual recognition" of this intent to repay. If the loan was not bona fide, you should then recharacterize the "loan" as income from fraudulent activities, a dividend, or compensation. Mere misrepresentation does not negate a true loan. There must be evidence the borrower did not intend to repay.

Where there is evidence of misrepresentation but you choose to look to discharge of the debt as the income event, Bartel would seem to prevent the taxpayer from arguing that the purported loan never was a real loan.

The closure of the S&L by a government agency or by the S&L filing a bankruptcy petition will normally not discharge the borrower's debt. The loan will be discharged, triggering the realization of discharge of indebtedness income, if the borrower buys back the debt for less than the face amount, the S&L or its successor agree to settle the debt for less than the amount owed, the S&L or its successor cancels the debt, or the debt is discharged by the bankruptcy court when the borrower files bankruptcy. In the absence of one of these events, discharge of indebtedness income is realized when the statute of limitations bars collection of the debt, unless some earlier event makes it apparent that the creditor no longer intends to collect.

If you have any questions, please contact Johnnel St. Germain at FTS 566-4430. We would be happy to provide you with any further assistance required either to clarify this memo or to address the facts in a specific case.

Paul L. Kane
Senior Technician Reviewer
Branch 3